Stocks Expanding Dominance Over Higher-Risk Bonds

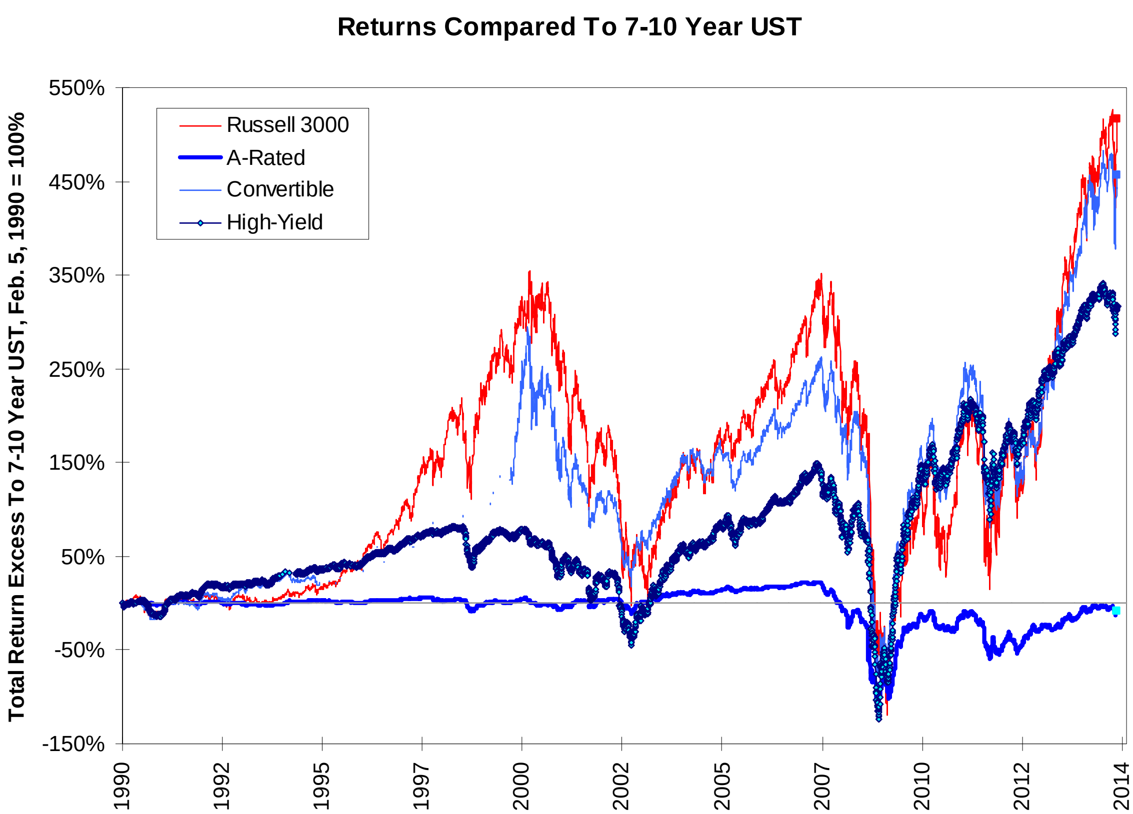
You know you are entering adulthood when they stop telling you to eat your vegetables and start telling you risk and return are correlated. You listen dutifully, are pleased that you did when the market rises and wonder just what you were thinking after the trapdoor opens, as trapdoors are wont to do every now and then.

Part of this financial culture – and a "culture" is simply a system of shared beliefs for those of you who dozed off during your various social sciences classes – is a mental ranking: Stocks are riskier than convertible bonds, which are riskier than high-yield bonds, investment-grade bonds and Treasury bonds, and in that order. You therefore expect to be rewarded accordingly, as if there is some magical tooth fairy or populist politician in the sky who will compensate you simply for taking on more risk.

Returns Vs. 7-10 Year Treasuries

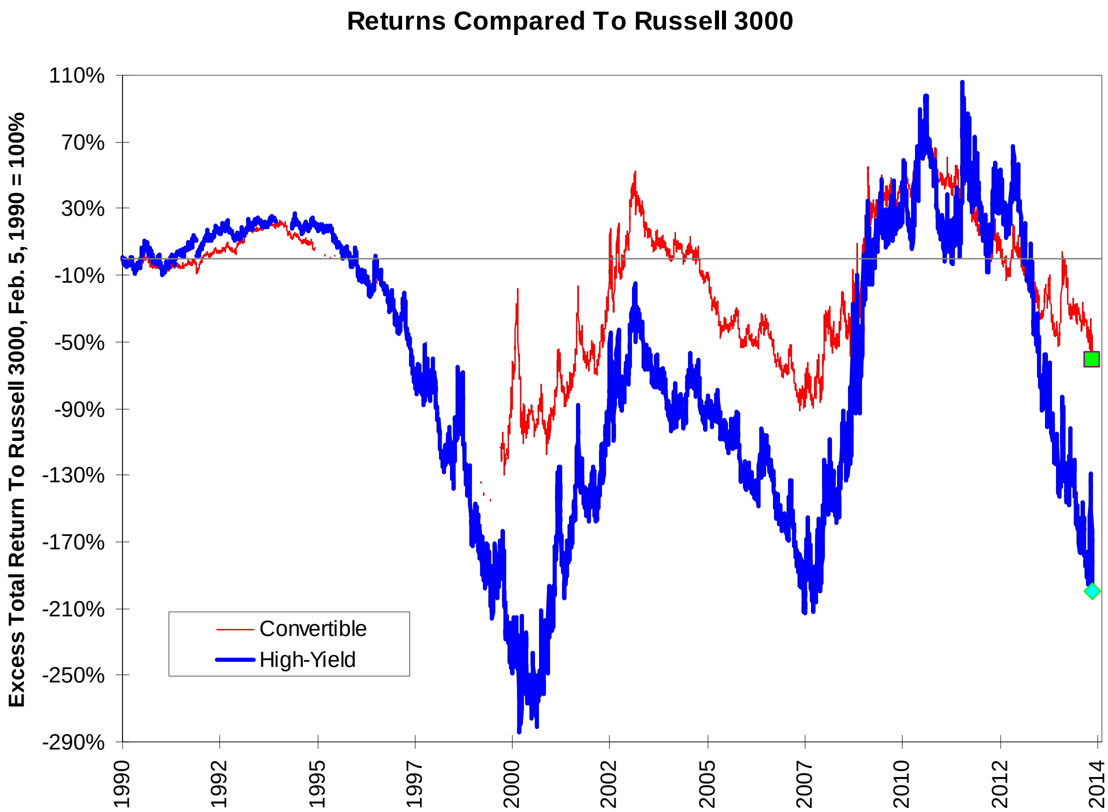
Let's map the excess returns of the Russell 3000, A-rated+ investment-grade, non-mandatory convertible bonds and high-yield bonds relative to 7-10 year UST going back to February 1990. While equities are leading the pack, this was not the case as recently as April and January 2013 for high-yield and convertible bonds, respectively. This inverted hierarchy of returns was attributable to the artificial compression of credit spreads and the artificial bullish flattening of the yield curve.

An even more interesting long-term surprise has been the underperformance of A-rated+ corporate bonds vis-à-vis Treasuries. While you are supposed to be rewarded for taking on the risk of corporate credit, these bonds have underperformed since markets began to tip lower in October-November 2007. Investors have prized Treasuries over investment-grade corporates systematically for their role as a haven during times of turmoil and for their role as an instrument of official policy in various policy shenanigans. These embedded liquidity options are generally ignored but have proven more valuable than these corporate bonds' higher yields. In addition, the recent experience of liquidity vacuums in corporate bonds attributable to Dodd-Frank and related regulatory constraints have embedded a short put option on liquidity into corporate bonds.



Returns Vs. Russell 3000

Now let's map the excess total returns of both convertible and high-yield bonds to the Russell 3000. Here we see just what a large disadvantage high-yield bonds' lack of an embedded call option on equities has been. Their excess return peaked on August 8, 2011, just before the announcement of Operation Twist at 105.7% and has declined steadily to a deficit of -199.69%...even though high-yield bonds have returned 32.43% over this period. Convertible bonds, in contrast, have returned 62.41% since August 2011; their excess total return vis-à-vis the Russell 3000 peaked on August 30, 2010, the date of Ben Bernanke's Jackson Hole speech hinting at QE2, at 83.3%. It now stands at -60.5%.



You may get compensated in principle for assuming more market risk, but no one compensates you for your foolishness in paying too much. What we are seeing now for both high-yield and convertible bonds are the results of a renewed downward compression of yields and credit spreads for high-yield. We can add the high delta and low gamma of convertible bonds' embedded call option on equities to this mix. Both classes of bonds face the embedded short put option on liquidity demonstrated during the September-October downturn. Restated, both of these asset classes have a poor risk/reward profile relative to equities at present.